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The Transferability of Non-Exclusive Copyright Licenses: A New Default Rule for Software in the Ninth Circuit

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The Transferability of Non-Exclusive Copyright Licenses: A New Default Rule For Software in the Ninth Circuit?

by
BRANDON M. VILLERY*

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Introduction

The merger and acquisition of companies using software technology can generate a need to transfer valuable software licenses from a target company to an acquiring company. High-technology companies retain software licenses for multiple purposes, including the internal use of modified software tools and the incorporation of such tools into software products. When a company is acquired, state law may recognize a transfer of rights where software licenses are transferred to an acquiring company from the target. However, as a default rule in the Ninth Circuit, a licensee cannot assign a non-exclusive copyright license without the express authorization of the licensor. Consequently, an acquired licensee may be forced to renegotiate an otherwise valid software license, even if it survives the acquisition and continues to operate as a subsidiary.

The issue of copyright license transferability was one of first impression for the Ninth Circuit in 1984.¹ To reach a decision, the court relied in part on case law addressing patent license transferability, stating: "Where precedent in copyright cases is lacking, it is appropriate to look for guidance to patent law 'because of the historic kinship between patent law and copyright law.'"² Upon review of federal copyright policies and applicable patent law, the Ninth Circuit determined that a non-exclusive copyright license cannot be transferred without the consent of the licensor.³

Still, parties can contractually waive the need for express authorization. This waiver can be efficient and effective in software licenses.⁴ However, some agreements are negotiated by unsophisticated parties and do not include a provision that deals with assignment. Small companies with such non-

1. See *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1333 (9th Cir. 1984).

2. See *id.* (quoting *Sony Corp. v. Universal City Studios, Inc.*, 464 U.S. 436, 439 (1984)).

3. See *id.* at 1333-35.

4. "[M]any software licenses contain express provisions permitting the license to be assigned or transferred under certain conditions. In such cases, the permissibility of a transfer of license rights will turn on whether the conditions for transfer were met or excused, not whether the transfer is permitted." Steven A. Marenberg and Elliot Brown, 'Scope of Use' Restrictions in Software Licenses, 10 No. 12 Computer Law. 13 (1993).

exclusive licenses are frequently purchased and integrated into larger corporations. The Ninth Circuit's default rule would prevent an assignment in these situations if state law recognized a transfer of rights following the merger.

In addition, companies that reorganize in bankruptcy often require the assumption and assignment of licenses to resume normal business operations or to facilitate an equitable return on assets. In these predicaments, the default rule: 1) prevents a debtor in possession from assuming the software license and rights enjoyed before bankruptcy; and 2) prevents a bankruptcy trustee from assigning a non-exclusive license to a third party in conjunction with the sale of assets, which bankruptcy law would otherwise allow (despite a license provision to the contrary). Understandably, the issue of copyright license transferability continues to pose a problem in mergers, acquisitions and bankruptcies.

This note will analyze the Ninth Circuit's decision to prohibit the assignment of copyright licenses and, more particularly, its impact on software licenses. The proposed policies for restricting the transfer and assignment of copyright licenses will be discussed. Moreover, this note will illustrate why a separate rule should be recognized for the assignment of software licenses in mergers and bankruptcies.

The growing realm of software licensing has produced a unique environment where licenses are the lifeblood of corporations. The rule enunciated by the Ninth Circuit should be changed to promote the efficient utilization of software and resources. While this note does not advocate the establishment of a secondary market for software licenses, an exception to the default rule should be made.

I

Background

A. Assignment Is Controlled by Federal Common Law

The assignment of contractual rights under a patent or copyright license by a licensee is not addressed in the Patent Act⁵ or Copyright Act.⁶ Consequently, a licensee must rely on

5. United States Patent Act, 35 U.S.C.A. §§ 1-376 (West 1983 & Supp. 1999).

6. Copyright Act of 1976, 17 U.S.C. §§ 101-1332 (West 1996 & Supp.

common law to determine if a license can be transferred without the consent of the licensor when the agreement does not address the issue. Generally, state contract law governs the interpretation of licenses⁷ under principles derived from the *Erie* doctrine.⁸

There has been some confusion and controversy regarding the applicability of state law to the assignment of patent licenses following *Erie*.⁹ However, it appears settled that the assignment of rights under a patent or copyright license is governed by federal common law.¹⁰ Unfortunately for licensees, federal common law prevents the application of state principles that favor transferability.¹¹

B. When Do Assignment Issues Arise?

1. Mergers and Bankruptcies

Case law demonstrates that assignment issues frequently arise in two instances: 1) merger and acquisition activity; and 2) the assumption and assignment of executory contracts during bankruptcy.¹² In the first instance, an acquired or merged licensee seeks to utilize the contractual rights that it enjoyed before the change of ownership. In the second instance, a trustee or debtor in possession seeks to assume the license of a failed company and, in some cases, assign that license to a third party.¹³ Prior to the Ninth Circuit's decisions in *Everex Systems, Inc. v. Cadtrak Corporation*¹⁴ and *Perlman v. Catapult Entertainment, Inc.*,¹⁵ it was understood that a license could be assumed by the trustee and assigned

1999).

7. See *Everex Sys., Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 677 (9th Cir. 1996) (citations omitted).

8. See *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938).

9. See, e.g., *Farmland Irrigation Co. v. Dopplmaier*, 308 P.2d 732, 737-39 (Cal. 1957).

10. See *Everex*, 89 F.3d at 677-80; see also *SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458, at *5 (N.D. Cal. 1991).

11. See *Everex*, 89 F.3d at 677-80.

12. See *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747 (9th Cir. 1999); see also *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), *SQL Solutions*, 1991 WL 626458 (N.D. Cal. 1991).

13. See *Harris*, 734 F.2d at 1332; see also *Everex*, 89 F.3d at 673.

14. *Everex*, 89 F.3d at 673.

15. *Perlman*, 165 F.3d at 747.

in a bankruptcy proceeding pursuant to section 365 of the Bankruptcy Code, notwithstanding federal common law to the contrary.¹⁶

However, the Ninth Circuit has held that section 365(c) of the Bankruptcy Code¹⁷ disallows such an exception to federal common law.¹⁸ Other circuits will presumably follow this

16. Generally, "Section 365 of the Bankruptcy Code gives a trustee in bankruptcy (or, in a Chapter 11 case, the debtor in possession) the authority to assume, assign, or reject the executory contracts and unexpired leases of the debtor, notwithstanding any contrary provisions appearing in such contracts or leases." *Id.* at 749 (citing 11 U.S.C. § 365(a) & (f)). Backed by this provision, bankruptcy trustees and reorganized debtors have endeavored to assume the rights granted under non-exclusive copyright licenses, and in some instances to assign those rights to a third party, despite non-assignment provisions in the actual agreement. *See id.* at 749-50; *see also Institut Pasteur*, 104 F.3d at 490-91; *Everex*, 89 F.3d at 674-75.

17. A trustee's or reorganized debtor's ability to assume and assign contracts is not absolute. *See Perlman*, 165 F.3d at 749. Section 365(c) of the Bankruptcy Code provides that:

[A] trustee [or reorganized debtor (debtor in possession)] may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if -

(1) (A) *applicable law* excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment or rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment. . . .

11 U.S.C. § 365(c) (emphasis added).

18. In *Everex*, the Court of Appeals for the Ninth Circuit held that the federal rule prohibiting the assignment of non-exclusive patent licenses constitutes "applicable law" under Section 365, stating that: "Federal law . . . would excuse Cadtrak [the licensor] from accepting performance from, or rendering it to, anyone other than CFLC [the licensee]." *Everex*, 89 F.3d at 679. Consequently, the debtor in *Everex* was unable to assume and assign a non-exclusive patent license to a company purchasing its remaining assets in bankruptcy. *Id.*

More importantly, in *Perlman*, the Ninth Circuit held that a debtor corporation reorganizing in bankruptcy (a merger following bankruptcy where the debtor would operate as a subsidiary), could not assume the rights under a non-exclusive patent license enjoyed prior to the implementation of its reorganization plan. *Perlman*, 1999 WL 33702 at *2. Unlike *Everex*, there was no actual assignment of rights to a third party in *Perlman* because the court viewed the reorganized debtor as the original licensee requesting assumption of its own contract. *Id.* at *2-3. The licensee did not dissolve following the merger and bankruptcy. *See id.* at *2. Still, the court held that Section 365(c)

by its terms bars a debtor in possession from assuming an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party. The literal language of § 365(c)(1) is thus said to establish "hypothetical test": a

decision in accordance with the persuasive value traditionally assigned to Ninth Circuit opinions. Thus, when a license does not address assignment, the default rule prohibiting the transfer of rights by a licensee is the same in mergers, acquisitions and bankruptcy proceedings.

2. *End-User License vs. "Copyright Use" License*

There is a distinction between widespread end-user¹⁹ licenses and software agreements that resemble the typical mechanical copyright license.²⁰ The former agreement allows the licensee to transfer limited use rights in a single copy of software, while the latter gives rise to assignment issues.²¹

Ordinarily, an end-user license transfers title in a single copy of software and the licensor retains all copyright ownership in the work.²² The end-user (licensee) receives the "general right to possess and use the software."²³ As the

debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party.

See *id.* (citations omitted) (emphasis added).

In contrast, the Court of Appeals for the First Circuit held that a similar debtor in possession was not a different entity from that in the original patent license and federal law did not preclude the assumption of the patent license under Section 365(c). See *Institute*, 104 F.3d at 493-94. The First Circuit applied a different interpretation of Section 365 in which the debtor could assume the non-exclusive patent license because an assignment to a third party would not transpire, actually or hypothetically. See *id.* at 493. Hence, a split in the Circuits is evinced by the First and Ninth Circuits incompatible interpretations of Section 365(c). However, and of great significance, both Circuits seem to agree that under the controlling state law in each case (California and Massachusetts), no actual assignment takes place where a target corporation survives and continues to operate following a merger or reorganization. See *Perlman*, 1999 WL 33702 at *2-4; see also *Institute*, 104 F.3d at 493-94. This indicates that in both states, a merged licensee may be able to exercise rights under a license if it does not file for bankruptcy.

19. An end-user is "[t]he ultimate user of a computer or computer application in its finished, marketable form." MICROSOFT PRESS COMPUTER DICTIONARY 176 (3d ed. 1997).

20. Typically, a mechanical license refers to an agreement that "gives the right to reproduce, distribute, and sell copyrighted work . . ." See *SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458, *5 (N.D. Cal. 1991).

21. See *id.* at *5-6.

22. See Stephen Y. Chow, *Intellectual Property Licensing Under UCC 2B*, 532 PLI/Pat 723 (1998).

23. See *SQL Solutions*, 1991 WL 626458 *5 (citing *S.O.S. Inc. v. Payday Inc.*, 886 F.2d 1081, 1088 n.8 (9th Cir. 1989)).

lawful owner of a copy of protected software, federal copyright law allows the end-user to make copies when necessary to utilize the computer program²⁴ and for archival purposes.²⁵ Moreover, under the first sale doctrine, the end-user is entitled to transfer title to the copy of software without the authorization of the copyright owner.²⁶ The transferee retains the same statutory rights enjoyed by the original end-user and may use the software subject to the restrictions in the license.²⁷ Consequently, issues of assignment and transferability do not arise in the typical end-user license.

In contrast, a software license may raise assignment and transferability concerns when it allows use "otherwise reserved to the copyright holder"²⁸ Often, these agreements resemble traditional mechanical copyright licenses, where the grant may include the right to reproduce, distribute, or modify²⁹ the copyrighted software.³⁰ For instance, software companies frequently obtain licenses for source code³¹ that is imbedded or simply distributed with their own software products. Also, companies may obtain a license to modify another's software, thereby creating a derivative work, by producing and selling a separate program that adds features or functionality to the original licensed software. Licenses of this kind encompass more than

24. The Ninth Circuit held in *MAI Systems Corp. v. Peak Computer, Inc.*, 991 F.2d 511, 518 (9th Cir. 1993), that a reproduction occurs for purposes of copyright law when a software program is loaded in the Random Access Memory (RAM) of a computer. This step is essential in the utilization of computer programs.

25. See 17 U.S.C. §117.

26. The first sale doctrine provides that once a copyright owner has transferred title in a copy of the protected work, the ability to restrict or control re-transfer of that copy to subsequent third parties is lost. See 17 U.S.C. §109.

27. However, proposed drafts of the UCC 2B produced confusion and controversy regarding the transfer of title in typical end-user licenses and the ability of a copyright owner to retain rights that could restrict the re-transfer of such copies. See David A. Rice, *License With Contract And Precedent: Publisher-Licensors Protection Consequences And The Rationale Offered For The Nontransferability of Licenses Under Article 2B*, 13 BERKELEY TECH. L.J. 1239 (1998).

28. *S.O.S. Inc. v. Payday Inc.*, 886 F.2d 1081, 1088 n.8 (9th Cir. 1989).

29. Modifications are generally unattainable with an end-user license, where the end-user acquires software in object code only.

30. See *SQL Solutions*, 1991 WL 626458 *5.

31. Source code refers to "[h]uman readable program statements . . . that are not directly readable by a computer." MICROSOFT PRESS COMPUTER DICTIONARY 176 (3d ed. 1997).

personal use of a single software copy. The licensee's rights include a "copyright use" subject to federal law regarding assignment.³²

C. The Adoption And Recognition Of The Default Rule.

1. The Harris Decision.

The Ninth Circuit's decision in *Harris v. Emus Records Corp.* established a default rule for the assignment of a non-exclusive copyright license by a licensee.³³ In 1968, a singer named Emmylou Harris recorded six songs for an album entitled *Gliding Bird*.³⁴ Harris recorded the songs pursuant to an agreement with Jay-Gee Record Company that entitled Harris to receive royalties on each record sold.³⁵

The songs written and composed by Harris were copyrighted and held in the name of three companies as joint copyright owners, including a company wholly owned by Harris.³⁶ In 1969, the companies issued mechanical licenses to Jay-Gee and the album was subsequently released.³⁷ In 1971, Jay-Gee filed for bankruptcy and its trustee sold part of the company's assets to Suellen Productions Inc.³⁸ In this purchase, Sullen acquired a master tape that contained the six songs recorded for the *Gliding Bird* Album.³⁹

Suellen transferred any and all rights acquired to manufacture and distribute the recordings on the *Gliding Bird* Album to the defendant, Emus Records.⁴⁰ Emus re-released the *Gliding Bird* Album with a new cover and serial number.⁴¹ Harris never received royalty payments from Emus and consequently filed suit for copyright infringement.⁴² As expressed by the court, "the ultimate question [was] whether copyright licenses can be transferred by a mere licensee."⁴³

32. See *SQL Solutions*, 1991 WL 626458 *5.

33. *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1334 (9th Cir. 1984).

34. See *id.* at 1331.

35. See *id.*

36. See *id.*

37. See *id.*

38. See *id.* at 1332.

39. See *id.*

40. See *id.*

41. See *id.*

42. See *id.*

43. *Id.* at 1333.

Relying, in part, on case law discussing the transferability of patent licenses, the court concluded that a copyright license cannot be transferred by the licensee without the express authorization of the licensor.⁴⁴ As a licensee, Jay-Gee could not assign its mechanical licenses to a third party without the consent of the joint copyright owners,⁴⁵ even in bankruptcy.⁴⁶ "Although [the] defendants obtained the master tapes, they did not thereby obtain a license to mechanically reproduce them."⁴⁷ Without a mechanical license, Emus Records was held liable for infringing the copyrights of Harris by its release of a new *Gliding Bird* album.

2. *The SQL Solutions Decision*

Although the license agreement in *SQL Solutions, Inc. v. Oracle Corp.*⁴⁸ contained an express provision prohibiting assignment by the licensee, Judge Patel's opinion includes relevant assignment analysis. *SQL Solutions* involved the transfer of a software license by a licensee⁴⁹ in the context of a reverse triangular merger.⁵⁰ In 1987, D & N Systems Inc. ("D & N") entered into a software license agreement with Oracle Corporation.⁵¹ D & N received a perpetual non-exclusive license to use Oracle software in its internal operations.⁵² In addition, the license allowed D & N to "modify Oracle software, to combine it with other software products, and to copy the software for archival and backup purposes."⁵³

44. *See id.* at 1333-34.

45. *See id.* at 1334-35.

46. In *Harris*, the Ninth Circuit considered whether copyright licenses pass to bankruptcy trustees under section 70(a)(2) of the Bankruptcy Copyright Act of 1898, despite a default rule to the contrary. *Id.* at 1334. Section 70(a)(2) of the Bankruptcy Act of 1898 provided that "interests" in copyrights vest in bankruptcy trustees. *See id.* However, the court found that "for purposes of § 70(a)(2) a license is not an interest in a copyright." *Id.*

47. *Id.*

48. 1991 WL 626458 (N.D. Cal.).

49. *See id.* at *1-2.

50. A reverse triangular merger is "[a] merger in which the acquiring corporation's subsidiary is absorbed into the target corporation, which becomes a new subsidiary of the acquiring corporation." BLACK'S LAW DICTIONARY 413 (pocket ed. 1996).

51. *See SQL Solutions*, 1991 WL 626458 at *1.

52. *See id.*

53. *Id.*

D & N utilized the software to create additional software products that worked in conjunction with, and improved Oracle's relational database management systems.⁵⁴ Also, the license included a provision that expressly prohibited assignment or transfer without the written consent of Oracle.⁵⁵

In 1990, D & N merged with a subsidiary of Sybase, Inc.⁵⁶ In this reverse triangular merger, the subsidiary of Sybase dissolved, leaving D & N as the surviving corporation.⁵⁷ D & N changed its name to SQL Solutions, Inc. ("SQL") and became a wholly owned subsidiary of Sybase through an exchange of stock ownership.⁵⁸ Oracle then claimed that D & N (now SQL) breached their agreement by transferring the copyright license to SQL.⁵⁹

Initially, SQL maintained that a transfer of rights did not occur because D & N continued to operate as a subsidiary and did not dissolve.⁶⁰ Applying California law, the court found that an assignment or transfer of rights did occur through a change in the legal form of ownership of a business.⁶¹ Notwithstanding the anti-assignment provision of the license, the court proceeded to determine whether federal law prohibited the transfer.⁶²

Judge Patel noted the Ninth Circuit's decision in *Harris* which "enunciated a prohibition against the transfer of copyright licenses."⁶³ Like the *Harris* court, she stressed the importance and influential strength of patent law when determining the assignability of a copyright license.⁶⁴ Judge Patel verified that federal law prohibits a licensee from assigning a non-exclusive copyright license without the consent of the licensor in any merger where state law

54. See *id.* at *2.

55. See *id.*

56. See *id.* The subsidiary of Sybase Inc. was a shell corporation created for tax purposes only. See *id.*

57. See *id.*

58. See *id.*

59. See *id.*

60. See *id.* at *3-4.

61. See *id.* at *4.

62. See *id.* at *5-6.

63. *Id.* at *6.

64. See *id.*

recognizes a transfer of rights.⁶⁵ Having made this determination, Judge Patel found D & N in breach of the agreement for violating the anti-assignment provision and Oracle was entitled to terminate the license.⁶⁶

II Analysis

A. Rationale for the Default Rule

1. *A Copyright License is Personal to the Licensee*

Pursuant to the Ninth Circuit's decision in *Harris v. Emus Records Corp.*, the law regarding patent license assignment has influenced, if not determined, the default rule for non-exclusive copyright licenses.⁶⁷ As stated by the Ninth Circuit: "Where precedent in copyright cases is lacking, it is appropriate to look for guidance to patent law because of the historic kinship between patent law and copyright law."⁶⁸ Thus, to understand the justifications for the default rule on copyright license assignment, a number of issues and policies concerning the transferability of non-exclusive patent licenses must be analyzed. Whether a patent license is a personal contract evokes such an examination.

In *Troy Iron and Nail Factory v. Corning*, the United States Supreme Court indicated that a non-exclusive patent license "is only the grant of a personal power to the licensee, and is not transferable by him to another."⁶⁹ Although this assertion was provided as dicta,⁷⁰ and despite the absence of reasoning and explanation for such a declaration, it has been relied upon and cited as the controlling authority regarding the transfer of patent licenses.⁷¹ Still, no other decision has

65. *See id.*

66. *See id.*

67. *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1333 (9th Cir. 1983).

68. *Id.* (quoting *Sony Corp. of Am. v. Universal City Studios*, 464 U.S. 417 (1984)).

69. *Troy Iron & Nail Factory v. Corning*, 55 U.S. 193, 216 (1852) (citing CURTIS ON PATENTS, sec. 198 and 2 Story's Reports, 525, 554).

70. *See Farmland Irrigation Co., Inc. v. Dopplmaier*, 48 Cal.2d 208, 221 (1957).

71. A patent license confers a right that is merely personal, "not transferable, and [is] extinguished with the dissolution of [a] corporation." *Hapgood v. Hewitt*, 119 U.S. 226, 233 (1886); *see also Unarco Indus., Inc. v.*

adequately clarified or contributed to the rationale for preserving this broad default rule. Instead, several decisions have merely expressed that "[t]he prohibition against transfer of patent licenses is longstanding and frequently invoked."⁷²

However, in *Farmland Irrigation Co., Inc. v. Dopplmaier*, Justice Traynor of the California Supreme Court admirably scrutinized the 1852 default rule and concluded that it lacked utility and logical underpinning.⁷³ Although federal law seemingly controls the transferability of non-exclusive patent licenses,⁷⁴ Traynor's opinion provides useful insight and guidance. Ironically, the Ninth Circuit has acknowledged that Justice Traynor's "opinion raises not insignificant questions about the actual holdings, relevance, and continued vitality of the nineteenth-century . . . decisions [that] are cited [as] the origins of the [default] rule."⁷⁵

Understandably, a non-exclusive software license lacks provisions and terms to support a claim that they are by nature, personal.⁷⁶ In contrast to the non-exclusive patent license in *Oliver v. Rumford Chemical Works*,⁷⁷ a nineteenth-century decision frequently cited as controlling authority, non-exclusive software licenses commonly require performance from a corporate entity. Assuredly, performance from a corporate entity is not so distinctive or unique that it cannot be replicated with equal quality by a merged entity or acquiring corporation (operating under the precise requirements of the original contract). A software license between corporate parties infrequently requires the personal skill, ability or qualifications of a specific individual or individuals.

Moreover, the perpetual nature of many non-exclusive software licenses illustrates the absence of contractual characteristics commonly associated with personal service

Kelly, Co., 465 F.2d 1303 (7th Cir. 1972).

72. *SQL Solutions*, 1991 WL 626458 at *6.

73. *Farmland*, 48 Cal. 2d at 221.

74. See discussion *supra* Part II.A.

75. See *Everex Sys., Inc., v. Cadtrak Corp.* (In re CFLC, Inc.), 89 F.3d 673, 679-80 (9th Cir. 1996).

76. See *Farmland*, 48 Cal.2d at 221 (referring to *Oliver v. Rumford Chemical Works*, 109 U.S. 75, 82 (1883)). A non-exclusive software agreement that incorporates personal services should have "provisions in the license calling for the exercise of personal skill of the licensee." *Id.*

77. 109 U.S. 75 (1883).

agreements. It is not extraordinary to find corporations that exist and remain competitive for an extended number of years. A corporation may have a change in directors, managers, or other personnel throughout its existence.⁷⁸ It may suffer downturns and swings in productivity that are tied to the performance of these varying individuals. Despite such changes, a corporation's obligations are unlikely transformed. The rights under a perpetual non-exclusive software license would continue, notwithstanding the changes in skill, ability and qualifications of its employees.

The personal contract argument is further weakened if the payment of royalties is the only required performance. Royalty payments can be made by anyone. Permitting assignment "would [not] materially impair the nonassigning party's chance of obtaining the performance he expected."⁷⁹

An affirmation that every non-exclusive software license is personal should not be the default rule. As noted by Justice Traynor, "[a] flat statement that a license creates a merely personal right . . . [s]hould follow as a conclusion from an examination of the purposes and provisions of the particular license, rather than stand as a self-evident first principle."⁸⁰ Accordingly, a non-exclusive software license should be deemed personal when one or both parties to the contract are individuals.⁸¹ Otherwise, the default rule should presume that all software licenses between two corporate entities are not personal and therefore transferable. A licensor should then have the opportunity to rebut this presumption by showing that the license required the skillful performance of a specific individual. This pragmatic approach incorporates the nature of non-exclusive software licenses and is a logical departure from the default rule announced in 1852.

78. In *Farmland*, Justice Traynor noted that: "if [the licensor] thought that control of the corporation by a particular person was essential to assure an advantageous return of royalties, he would have provided against the possibility of that person's selling his interest." 48 Cal.2d. at 223.

79. *Id.* at 222.

80. *Id.*

81. "[T]he duties imposed upon one party may be of such a personal nature that their performance by someone else would in effect deprive the other party of that for which he bargained." *Id.*

2. *Permitting the Assignment of Non-Exclusive Software Licenses Would Create a Secondary Market and Reduce the Incentive to Create*

In addition to its reliance on patent law in fashioning the default rule for copyright licenses in *Harris*, the Ninth Circuit recognized that prohibiting the assignment of nonexclusive copyright licenses is in accord with policies underlying the enactment of the Copyright Act.⁸² Specifically, the court explained that:

The legislative history reveals an acute awareness of the need to delicately balance competing interests. On the one hand, there [is] a strong reluctance to allow a monopolization of works or compositions; at the same time, there [is] an awareness of the necessity of preserving the rights of authors and composers in order to stimulate creativity.⁸³

Conformably, several courts have justified the continued prohibition of non-exclusive license transfer on the ground that such activity would create a secondary market for licenses that would diminish the author's ability to profit from his creation and thereby lessen the incentive to create.⁸⁴ As summarized by the Ninth Circuit in *Everex*, with regard to non-exclusive patent license transfer,

Allowing free assignability . . . of nonexclusive patent licenses would undermine the reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license from a licensee. In essence, every licensee would become a potential competitor with the licensor-patent holder in the market for licenses under the patents.⁸⁵

To an extent, the Ninth Circuit's concern with assignability on this basis is notable and correct. Authorizing unconditional assignment in non-exclusive licensing arrangements could impair a copyright owner's monopoly in

82. *Harris*, 734 F.2d at 1334; see also *SQL Solutions*, 1991 WL 626458 *5.

83. *Harris*, 734 F.3d at 1334 (citing H.R. REP. NO. 2222, 60th Cong., 2d Sess. 7 (1909)).

84. See *Everex*, 89 F.3d at 679; see also *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 242 (1997).

85. *Everex*, 89 F.3d at 679. This allegation was made in the court's discussion of federal policy that justifies application of the default rule over California law. See *id.*

three conceivable instances: 1) outright sales by corporations not engaged in mergers or bankruptcies; 2) sublicensing of rights under a license; and 3) the assignment of a license to a direct competitor. However, these considerations may be resolved by a narrow default rule that permits limited assignment instead of unobstructed assignment.

First, a default rule allowing transfer only in a merger, acquisition or bankruptcy would place a pragmatic deterrent on the unfettered sale of rights by a licensee. A third party seeking the rights enjoyed by a licensee would be unable to purchase those rights independently of a merger, acquisition or bankruptcy proceeding. A feasible secondary market for license rights would not exist. Transaction costs would presumably prevent mergers and acquisitions based solely on the desire to acquire rights under a license. Moreover, it seems inconceivable that a flourishing corporation would file for bankruptcy merely to transfer license rights to some third party.

Second, a new default rule should not be construed or drafted to allow sublicensing of rights in any agreement unless expressly permitted in the instrument itself. Undoubtedly, there is no reason to presume that a default rule allowing transfer in a merger, acquisition or bankruptcy proceeding would thereby allow sublicensing. "[A copyright owner] could . . . control the absolute number of licenses in existence"⁸⁶ under a default rule that permits assignment. The right of the copyright owner to control the number of licensees must not be obstructed. By controlling the absolute number of licensees, a copyright owner is guaranteed payment on every license issued, most likely in the form of royalties or a lump-sum payment by the original licensee. A default rule allowing the assignment of non-exclusive software licenses, excluding the right to sublicense, "would not hamper the [copyright owner's] right to profit from his monopoly by licensing under it."⁸⁷ Licensees would not profit from the licensor's monopoly through unauthorized sublicensing, preventing the existence of this type of secondary market.

Third, a new default rule could mandate that any

86. *Id.*

87. *Farmland*, 48 Cal. 2d at 220.

assignment is invalid upon a showing by the licensor that the transfer will have a detrimental impact on the licensor's monopoly. For example, a licensor could invalidate a transfer by proving that the license was transferred to a direct competitor, including "a party whom the [copyright owner] itself might be . . . unwilling to license."⁸⁸ This requirement would prevent the licensor from refusing consent in a transfer to demand higher licensing fees.⁸⁹ A licensor should be able to control the use of its intellectual property, but it should not be allowed to exact higher fees simply because the original licensee has merged or reorganized under bankruptcy law.

3. *Assignment Would Impede the Licensor's Ability to Monitor Use and Collect Royalties*

A licensor's capacity to collect royalties was an unmistakable concern of the Ninth Circuit in *Harris*.⁹⁰ Indeed, this particular issue related to the court's analysis of the competing interests underlying the enactment of the Copyright Act—balancing the reluctance to grant a monopoly with the desire to promote creativity. In comparing the notice requirement in compulsory licenses⁹¹ with the need of a licensor to determine which entities are required to pay royalties, the court expressed that:

[t]he notice provision for compulsory licenses insures that the copyright owner can monitor use in order to determine that accountings are accurate. The same consideration is relevant [where a licensee transfers his rights under a license]. By licensing rather than assigning⁹² his interest in the copyright, the owner reserves certain rights, including that of collecting royalties. His ability to monitor use would be jeopardized by allowing [transfer or assignment by the licensee] without notice.⁹³

Understandably, a licensor must be able to efficiently and accurately collect royalties on the use of his intellectual

88. *Everex*, 89 F.3d at 679.

89. See *Institute Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997).

90. 734 F.2d at 1334.

91. The compulsory licensing provision of the Copyright Act "permitted the copyright holder to control first use while providing a mechanism for others to obtain licenses once first use had been authorized." *Id.*

92. The court's reference to assignment in this instance was that of a copyright owner that relinquishes his rights in the intellectual property; rather than licensing—where the copyright owner retains ownership. See *id.*

93. *Id.*

property. However, prohibiting every assignment of non-exclusive copyright licenses is a sweeping response to this reasonable, but modest, concern.

In *Harris*, the Ninth Circuit evidently concluded, in part, that consent is required for transfer because notice of transfer is central to the licensor's ability to collect royalties.⁹⁴ Yet, the court should have supplied a full explanation of the connection between notice and the requirement of consent. A default rule can be constructed to require notice but not consent—one is not necessarily dependent upon the other. In requiring that all licensees provide notice to the licensor upon transfer or assignment of their rights under a license, the licensor would have the information necessary to track and monitor royalty payments.

A second consideration associated with the notice requirement is the ability of the licensor to monitor the actual use of intellectual property. Specifically, this refers to the ability of a licensor to ensure that the licensees are not engaged in unauthorized use of the copyrighted work—use outside the scope of the grant embraced by the terms of the agreement.

This concern was recognized in *First Nationwide Bank v. Florida Software Service, Inc.*,⁹⁵ where the defendant intellectual property owner claimed that “anti-assignment [is] designed to protect [the intellectual property owner] from unauthorized use of . . . computer software.”⁹⁶ However, the district court observed that “no trade secret violations occurred as a result of the [acquisition at issue], no unauthorized use of the software took place and [the intellectual property owner] continued to receive all payments due under the original contract.”⁹⁷

It would be inappropriate to assume that every recipient of a non-exclusive software license, by transfer, will engage in unauthorized use. In fact, whether a license is acquired by assignment or from the licensor, the recipient is bound to act in accordance with the terms of the original agreement. To accommodate the interest of the licensor in ensuring

94. *Id.*

95. 770 F.Supp. 1537, 1540, 43 (1991).

96. *Id.*

97. *Id.* at 1543.

authorized use, a default rule need only require notice whenever a non-exclusive license is transferred. As noted by the district court in *First Nationwide Bank*, "no desirable public policy is served" in preventing a transfer merely to suppress potential unauthorized use and allow the licensor to demand higher fees.⁹⁸ Notice is all that is required.

B. The Default Rule and the Demand for Higher Licensing Fees

The default rule provides licensors with an unreasonable power to squeeze an additional sum of money from reorganized and merged corporations.⁹⁹ Although a non-exclusive software licensee can transfer his rights with the express authorization of the licensor, there is no requirement or principle that controls the licensor's refusal to provide consent. In a common reverse triangular merger, which frequently amounts to a mere change in stock ownership, a licensor retains the right to refuse authorization until a second licensing fee is paid by the same corporate entity that negotiated the original instrument. Fundamentally, such unreasonable conduct would be "contrary to the spirit of good faith and cooperation implied in [many licensing agreements where reasonable consent is expected]."¹⁰⁰

In *First Nationwide Bank*, the president of the defendant software corporation acknowledged that his corporation withheld consent merely because "the newly acquired institutions would not pay the [substantially] increased license fees."¹⁰¹ The defendant withheld consent notwithstanding assurances by the original licensee that no unauthorized use of the software would occur following the merger.¹⁰² In the words of the district court, the actions of the defendant amounted to "an attempt at extortion" and represented "an undeserved windfall as a result of the unfortunate circumstances which forced [the licensee] into

98. *Id.*

99. See Stephen J. Davidson, *Selected Legal And Practical Considerations Concerning 'Scope Of Use' Provisions*, 10 NO. 10 COMPUTER LAW 1, *1 (1993). "[The default rule] may be used by the licensor in an effort to extract excessive license or renewal fees after the licensee has become reliant on the software in its business." *Id.*

100. *First Nationwide Bank*, 770 F. Supp. at 1543.

101. *Id.*

102. See *id.* at 1540.

insolvency."¹⁰³ When a licensor fails to address assignment in the terms of a license, he should not be able to demand that the same legal entity, as recognized under corporate law, pay an additional penalty for becoming insolvent and selling its stock to a third party. Essentially, to allow such a demand would grant a licensor the power to punish a licensee for using an unsuccessful business plan.

Additionally, the foreseeable risk of higher licensing fees and license termination intervenes in bankruptcy decision making. "Non-exclusive patent licenses [for example.] frequently are the economic centerpiece . . . of a high-technology business. When that is the case for an economically distressed licensee, any consideration of a Chapter 11 case for such a company must be tempered by caution if the license does not expressly permit assignment by the licensee."¹⁰⁴

C. The Default Rule Can Produce Unequal Results

1. *The SQL Solutions Decision vs. The Perlman Decision*

As previously mentioned, the district court in *SQL Solutions* found that a transfer of rights is legally recognized in a reverse triangular merger under California law.¹⁰⁵ Accordingly, the district court applied the federal rule regarding non-exclusive copyright license transferability and concluded that the merged corporation could not exercise its rights under the license.¹⁰⁶ This is in contrast to the Ninth Circuit's decision in *Perlman v. Catapult Entertainment, Inc.*¹⁰⁷

In *Perlman*, the Ninth Circuit implicitly recognized that a transfer of rights does not occur in a merger where the target corporation survives and continues to operate as a distinct legal entity.¹⁰⁸ The Ninth Circuit was compelled to decide whether section 365(c) of the Bankruptcy Code prevented a

103. *Id.* at 1543.

104. Adam A. Lewis, *9th Circuit Holds Non-Exclusive Patent Licensee Cannot Assign License Without Licensor's Consent*, 15-OCT AM. BANKR. INST. J. 30, *30 (1996).

105. *SQL Solutions*, 1991 WL 626458, *3-4.

106. *See id.* at *5-6.

107. *Perlman v. Catapult Entertainment, Inc.*, (In re Catapult Entertainment, Inc.), 165 F.3d 747 (9th Cir. 1999).

108. *Id.* at 754.

merged corporation from assuming a patent license in the midst of a bankruptcy proceeding.¹⁰⁹ The court applied a “hypothetical test” to determine if the license could be assumed by the licensee.¹¹⁰ Under the “hypothetical test,” the Ninth Circuit held that a licensee cannot assume a license if “applicable law” would prevent transfer of that license to a hypothetical third party.¹¹¹ Having decided that the federal rule prohibiting assignment and transfer constitutes “applicable law” for purposes of section 365(c), the Ninth Circuit determined that the Bankruptcy Code prevented the licensee from assuming its own license.¹¹²

Still, the fact that the Ninth Circuit applied the “hypothetical test” indicates that it did not consider the licensee a third party after the merger.¹¹³ If a transfer of rights had occurred as a result of the merger, application of the “hypothetical test” would be unnecessary, since the licensor could refuse performance from the licensee. In fact, the Ninth Circuit expressed that “subsection (c)(1) [of the Bankruptcy Code would] have to be applied a second time if the debtor in possession [(licensee)] wishes to assign the contract in question.”¹¹⁴ This assertion further demonstrates that the licensee’s assumption and exercise of rights under the license did not amount to a transfer or assignment.

In sum, the District Court in *SQL Solutions* found that a transfer of rights does occur in a merger where the licensee survives, while the Ninth Circuit did not. In a jurisdiction that interprets state law as the court did in *SQL Solutions*, the default rule will prevent assignment in reverse triangular mergers. Yet, the default rule will have no impact in a jurisdiction or court that does not recognize a transfer of rights in reverse triangular mergers. This distinction will create varying and unequal outcomes upon application of the default rule. This inconsistency could be avoided if the default rule allowed assignment when the licensee survived.

109. See *id.* at 748.

110. See *id.* at 749.

111. See *id.*

112. See *id.* at 754-55.

113. See *id.* at 749.

114. *Id.* at 752.

2. *The Institute Pasteur Decision vs. The Perlman Decision*

Similar inconsistencies are evinced when the First Circuit's decision in *Institute Pasteur* is compared with the Ninth's Circuit's decision in *Perlman*. Although the distinctions between these cases relate to the interpretation of the Bankruptcy Code, the results indicate how application of the default rule can produce irregular outcomes. Again, in *Perlman*, the Ninth Circuit applied a "hypothetical test" in interpreting the Bankruptcy Code.¹¹⁵ This "hypothetical test" would prevent a licensee from assuming a license when applicable law would prevent assignment to some "hypothetical" third party.¹¹⁶ The default rule constitutes applicable law and consequently prevents a licensee from assuming a license in bankruptcy.¹¹⁷

In contrast, the First Circuit adopted an "actual performance test."¹¹⁸ Under the "actual performance test," a licensee in bankruptcy cannot assume a license if the licensor would have to accept performance from an "actual" third party.¹¹⁹ In *Institute Pasteur*, the licensee was a target corporation that did not dissolve following the merger.¹²⁰ The licensee had no intention of assigning the license to a third party once assumed.¹²¹ Instead, the licensee sought to exercise the rights granted under the original license.¹²² The court held that the merged corporation could assume the license because the licensee did not constitute a third party and there was no indication of subsequent assignment.¹²³ Hence, under the "actual performance test," the default rule does not prevent a licensee from assuming a software license when that licensee has no intention of assigning it to a third party, hypothetical or not.

In short, the default rule prevents a debtor in possession (licensee) from assuming its own license in jurisdictions that apply the "hypothetical test." However, a licensee may

115. *See id.* at 749.

116. *See id.*

117. *See id.* at 750.

118. *See Institute Pasteur*, 104 F.3d at 493.

119. *See id.*

120. *See id.* at 490-91.

121. *See id.* at 494.

122. *See id.*

123. *See id.* at 493-94.

assume a license if the “actual performance test” described in *Institute Pasteur* is applied. In the “actual performance test,” the default rule does not prevent assumption, only assignment. This additional peculiarity demonstrates how the default rule can create incongruous law among the federal circuits. Furthermore, even if the United States Supreme Court addressed this bankruptcy issue, choosing one test over the other, it would not overcome the mismatched results that occur due to different interpretations of state law regarding the transfer of rights in merger activity, as in *SQL Solutions* and *Perlman*.

III Proposal

Several considerations control in shaping a new default rule for the assignment of non-exclusive software licenses. These considerations include: 1) whether the license requires performance by an individual (resembling a personal service contract); 2) whether the licensee should be able to assign or transfer the license at any time (or under particular circumstances); 3) whether the licensee can sublicense; 4) whether the licensee can assign or transfer the license to a direct competitor of the licensor; and 5) whether the licensor must receive notice of assignment or transfer.

The ideal solution to this issue would be the adoption of a new default rule by Congress and subsequent incorporation of that rule into the Copyright Act. This approach would eradicate inconsistencies among the federal circuits and provide a uniform rule that could be amended or altered at one time—rather than incrementally among the circuits. This default rule could correspond to the following:

A non-exclusive copyright license in computer software may be:

- a) assigned by a licensee in a merger or acquisition if:
 - 1) neither party to the license is an individual;
 - 2) the license does not expressly require substantial performance from a specific individual;
 - 3) the license is assigned to a merged or acquired entity that survives; and
 - 4) the licensee provides reasonable notice to the licensor before such assignment occurs, or
- b) assumed or assigned by a licensee in a bankruptcy

proceeding if:

- 1) neither party to the license is an individual;
- 2) the license does not expressly require substantial performance from a specific individual; and
- 3) the licensee provides reasonable notice to the licensor before such assumption or assignment occurs.

A licensor can invalidate an assumption or assignment under this provision by proving that substantial injury will result (including, but not limited to, assignment to a direct competitor of the licensor). This provision shall not be construed to allow sublicensing by any licensee without the express authorization of the licensor.

This proposed rule would allow assignment in mergers and acquisitions. However, it would prevent a licensee from assigning the license to a party other than itself (in a merged or acquired form) due to the survival requirement. The rule would avoid the development of a secondary market stemming from merger and acquisition activity. In addition, this default rule would constitute "applicable law" under the Bankruptcy Code. It would allow assignment to a third party in bankruptcy only and assumption by a debtor in possession so that a reorganized company could resume operations following bankruptcy.

IV

Conclusion

As software licenses continue to become an integral part of business, the need to secure rights granted thereunder will only increase. In many instances, a software license can represent a substantial portion of a corporation's value to investors and the public. When these licenses are terminated upon application of the current default rule, licensors have a unique opportunity to exact increased licensing fees. The default rule persists despite this activity and despite the questionable policies and rationale upon which it is based. A new default rule should be adopted that provides an exception in mergers, acquisitions and bankruptcies. Permitting assignment in these limited capacities reflects a balance between the goals of promoting creativity and limiting the right to a monopoly. It is a pragmatic compromise.